

Internal Revenue Service
Appeals Office

Department of the Treasury

Release Number: 200936038
Release Date: 9/4/09
Date: June 10, 2009

Person to Contact:

Employee ID Number:
Tel:
Fax:

A
B
C

Refer Reply to:

AP:FE:

A= .
B= .
C=

In Re:

EO Revocation

Form Required to be Filed:

1120

UIL – 501.03-30

Tax Period(s) Ended:

June 30, 2008 & June 30, 2009

**Last Day to File a Petition with the
United States Tax Court: SEP 08 2009**

Certified Mail

Dear

This is a final adverse determination as to your exempt status under section 501(c)(3) of the Internal Revenue Code (IRC). It is determined that you do not qualify as exempt from Federal income tax under IRC Section 501(c)(3) effective July 1, 2001.

Our adverse determination was made for the following reasons:

You are not operated exclusively for charitable, educational, or other exempt purposes. You did not engage primarily in activities which accomplish one or more of the exempt purposes specified in section 501(c)(3). More than an insubstantial part of your activities were in furtherance of a non-exempt purpose and you were operated for the purpose of serving a private benefit rather than public interests.

Contributions to your organization are not deductible under Code section 170.

You are required to file Federal income tax returns on the form indicated above. You should file these returns within 30 days from the date of this letter, unless a request for an extension of time is granted. File the returns in accordance with their instructions, and do not send them to this office. Processing of income tax returns and assessment of any taxes due will not be delayed because you have filed a petition for declaratory judgment under Code section 7428.

If you decide to contest this determination under the declaratory judgment provisions of Code section 7428, a petition to the United States Tax Court, the United States Court of Claims, or the district court of the United States for the District of Columbia must be filed within 90 days from the date this determination was mailed to you. Contact the clerk of the appropriate court for rules for filing petitions for declaratory judgment. To secure a petition form from the United States Tax Court, write to the United States Tax Court, 400 Second Street, N.W., Washington, D.C. 20217.

We will notify the appropriate State officials of this action, as required by Code section 6104(c). You should contact your state officials if you have any questions about how this determination may affect your state responsibilities and requirements.

If you have any questions, please contact the person whose name and telephone number are shown in the heading of this letter.

You also have the right to contact the Office of the Taxpayer Advocate. Taxpayer Advocate assistance is not a substitute for established IRS procedures, such as the formal Appeals process. The Taxpayer Advocate cannot reverse a legally correct tax determination, or extend the time fixed by law that you have to file a petition in a United States court. The Taxpayer Advocate can, however, see that a tax matter that may not have been resolved through normal channels gets prompt and proper handling. You may call toll-free, 1-877-777-4778, and ask for Taxpayer Advocate Assistance. If you prefer, you may contact your local Taxpayer Advocate at:

Taxpayer Advocate Service

Phone:

See the enclosed Notice 1214, Helpful Contacts for Your "Notice of Deficiency" for additional Taxpayer Advocate telephone numbers and addresses.

Sincerely,

TEAM MANAGER

Enclosures:

Notice 1214 Helpful Contacts for your 'Deficiency Notice'



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY
Internal Revenue Service

Legend
ORG= Name of organization
EIN= EIN Number

Taxpayer Identification Number:

EIN

Form:

Tax Year(s) Ended:
200X06, 200X06

Person to Contact/ID Number:

Contact Numbers:

Telephone:

Fax:

ORG

Certified Mail - Return Receipt Requested

Dear

We have enclosed a copy of our report of examination explaining why we believe revocation of your exempt status under section 501(c)(3) of the Internal Revenue Code (Code) is necessary.

If you accept our findings, take no further action. We will issue a final revocation letter.

If you do not agree with our proposed revocation, you must submit to us a written request for Appeals Office consideration within 30 days from the date of this letter to protest our decision. Your protest should include a statement of the facts, the applicable law, and arguments in support of your position.

An Appeals officer will review your case. The Appeals office is independent of the Director, EO Examinations. The Appeals Office resolves most disputes informally and promptly. The enclosed **Publication 3498**, *The Examination Process*, and **Publication 892**, *Exempt Organizations Appeal Procedures for Unagreed Issues*, explain how to appeal an Internal Revenue Service (IRS) decision. Publication 3498 also includes information on your rights as a taxpayer and the IRS collection process.

You may also request that we refer this matter for technical advice as explained in Publication 892. If we issue a determination letter to you based on technical advice, no further administrative appeal is available to you within the IRS regarding the issue that was the subject of the technical advice.

If we do not hear from you within 30 days from the date of this letter, we will process your case based on the recommendations shown in the report of examination. If you do not protest this proposed determination within 30 days from the date of this letter, the IRS will consider it to be a failure to exhaust your available administrative remedies. Section 7428(b)(2) of the Code provides, in part: "A declaratory judgment or decree under this section shall not be issued in any proceeding unless the Tax Court, the Claims Court, or the District Court of the United States for the District of Columbia determines that the organization involved has exhausted its administrative remedies within the Internal Revenue Service." We will then issue a final revocation letter. We will also notify the appropriate state officials of the revocation in accordance with section 6104(c) of the Code.

You have the right to contact the office of the Taxpayer Advocate. Taxpayer Advocate assistance is not a substitute for established IRS procedures, such as the formal appeals process. The Taxpayer Advocate cannot reverse a legally correct tax determination, or extend the time fixed by law that you have to file a petition in a United States court. The Taxpayer Advocate can, however, see that a tax matter that may not have been resolved through normal channels gets prompt and proper handling. You may call toll-free 1-877-777-4778 and ask for Taxpayer Advocate Assistance. If you prefer, you may contact your local Taxpayer Advocate at:

If you have any questions, please call the contact person at the telephone number shown in the heading of this letter. If you write, please provide a telephone number and the most convenient time to call if we need to contact you.

Thank you for your cooperation.

Sincerely,



R. C. Johnson

Director, EO Examinations

Enclosures:
Publication 892
Publication 3498
Report of Examination

ORG

Form 886-A

Legend

ORG= Name of organization

ORG1= Previous name of organization

AD= Address

ST= State

X= Year

NN=Name of individual

NP= Newspaper company

UU= Unrelated company

x= Amount

ORG TAX YEARS ENDING JUNE 30, 200X and JUNE
30, 200X

ISSUES PRESENTED:

1. Whether ORG is operated exclusively for exempt purposes described within Internal Revenue Code section 501(c)(3):
 - a. Whether ORG is engaged primarily in activities that accomplish an exempt purpose?
 - b. Whether more than an insubstantial part of ORG' activities are in furtherance of a non-exempt purpose?
 - c. Whether ORG was operated for the purpose of serving a private benefit rather than public interests?

FACTS

BACKGROUND

An audit of ORG (hereinafter ORG) was commenced on January 16, 200X for the years ending June x, 200X and June x, 200X.

ORG1., was incorporated under the laws of the ST as a non-stock, nonprofit corporation on December x, 199X. On August x, 199X, an amendment was filed with the State changing the name to the current ORG. In a determination letter dated February x, 199X, ORG was determined to be exempt from Federal income tax as an organization described in IRC section 501(c)(3). It was further determined to be classified as a public charity as described under IRC section 509(a)(2). ORG is located at AD, ST.

In its Articles of Incorporation, ORG stated its purposes to be:

- (a) Provide debt management programs, marketing programs and creditor contribution follow-up programs to consumers.
- (b) To assist indigent debtors in improving their finances through educating them as to better means of managing their money and seeking for them, if appropriate, an extension or other reorganization of their debts.
- (c) To do any other act or thing incidental to or connected with the foregoing purposes or in advancement thereof, but not for the pecuniary benefit or financial gain of its members, directors, or officers except as permitted under Article 5 of the Not-For-Profit Corporation Law.
- (d) In addition to the forgoing corporate purposes, the corporation shall have all of the general powers set forth in section 202 of the Not-For-Profit Corporation Law.
- (e) Nothing herein shall authorize the Corporation, directly or indirectly, to engage in or include among its purposes any of the activities mentioned in Not-For-Profit Law, Section 406b-u.

ORG was founded by NN, NN, and NN. The organization used a filing service to file its original Certificate of Incorporation with the ST. The organization engaged an attorney, NN, to file the Amended Certificate of Incorporation. NN also prepared and submitted the original Form 1023 application and served as the organization's legal counsel.

Per the Form 1023 application filed by the organization, the initial Board of Directors consisted of three individuals, NN, President/Secretary/Director, NN, Vice-President/Treasurer/Director, and NN, Director. It was

subsequently learned that NN is the wife of NN and NN, is the sister of NN.

The activities as stated in the original Internal Revenue Service Form 1023 application are to help reduce the incidence of personal bankruptcy by educating the public about personal money management skills and by assisting predominantly low-income individuals and their families with their financial problems. It was also stated that upon approval of the Form 1023 application, the organization would initiate three activities: (a) providing information to the general public on sound money management; (b) counseling individuals and families who have financial problems; and (c) preparing budget plans for those individuals and families who can benefit from them.

- (a) **Public Information:** The organization will prepare videos, pamphlets, and other educational materials on budgeting, buying practices, and the sound use of consumer credit. The material will be provided free of charge to religious organizations, civic groups, labor unions, businesses, and educational organizations. Knowledgeable speakers will also be furnished for these same audiences.
- (b) **Counseling:** Individuals and their families referred to the organization will receive personal counseling, from trained financial counselors, on budgeting and the appropriate use of consumer credit. They will also receive copies of the public information materials. Referrals are likely to be made by clergy, employers, labor unions, finance companies, creditors, and interested individuals. It is expected that a substantial percentage of the referrals will be low-income persons with moderate income persons making up the balance.
- (c) **Budget Plan:** As an adjunct to the counseling services which they receive any individuals or families who so request will receive assistance with the creation of a budget plan. Under such a plan, the organization will intercede with creditors to try to persuade them to accept partial periodic payments in satisfaction of the debt. The clients will then make voluntary fixed payments to this organization. The organization will in turn disburse these funds to the various creditors. Except for the fee paid to this organization, the clients will receive full credit against their debts for all amounts paid. It is anticipated that, in many instances, creditors will agree to accept less than the face amount of the debt when they understand that this organization is working with the clients on payment arrangements. This organization will not make loans to clients.

ACTIVITY DESCRIPTION

DMP Operations

ORG employed approximately x people who purportedly worked as "counselors". ORG hired "counselors" with no experience in counseling or in the field of education. The education levels among the "counselors" varied, however, "counselors" were required to have a high school diploma. New "counselors" would undergo a 16-hour training program when hired, to prepare them for their job and to prepare them for a certification exam.

ORG operated a call center whose purpose was to enroll clients in debt management plans. ORG contacted potential clients by purchasing "leads." This was its only source of potential clients. "Leads" are basically names and phone numbers of individuals who have shown an interest in eliminating their credit card debt. They are packaged and sold to credit counseling organizations by independent firms who generate the "leads" primarily through the internet and advertising. All contacts with clients were by phone, fax or email. A minimal number of contacts, if any, were made by 'walk ins'.

ORG operated as follows: The potential client's name and telephone number would be purchased from independent "lead" providers as discussed above. A "counselor" (hereinafter "employee") would contact this individual by telephone. During the phone call, the employee would attempt to enroll the individual in a DMP. The employee would ask the potential client for information regarding his current credit situation. The potential client would be asked to complete a monthly budget which includes all income and expenses. He would then be told that ORG can only handle unsecured debt. If the potential client still showed an interest in the DMP, he would be asked to complete enrollment forms which consisted of a creditor information worksheet, a budget form, a client agreement and an electronic funds transfer (EFT) form. Enrollment forms were sent via email, fax, regular mail or downloaded off of the ORG website. When the potential client returned the completed forms, the employee would review the Monthly Budget and discuss it with the him. The interest rate reductions and terms available from the credit card companies were actually communicated to ORG through its back office processor, UU, Inc. (hereinafter "UU"). The back office processor was the connection to the credit card companies. If the interest rates were lowered and the new payment was satisfactory to the potential client, he would enroll in the DMP and the first payment would be submitted.

ORG treated its employees as salespersons who were hired to sell DMPs. In the minutes to a Board of Directors meeting, the CFO, in a discussion on employee counselors, was quoted as saying that these employees "need to make money" and "money drives sales". Another quote from the minutes included "there will be no bonuses issued for under achievement". The CFO voiced "concern about top producers receiving favoritism" in reference to a discussion on certain employee counselors receiving the best "leads". When discussing the financial results during a Board meeting CFO NN spoke of the "average revenue per counselor" and alerted

Trustees to the fact that the "loss on sales has been consistent". In a discussion on "leads", CEO NN discussed making calls on old "leads" to get more "bang for the buck". These quotations are characteristic of a sales driven company. The corporate minutes reflected continuing concern about the productivity of the employee counselors in selling DMPs. NN also stated in an interview that counselors were encouraged to sign clients up for DMPs. In fact, counselors and managers were paid a base salary plus a production incentive. The incentives were as follows:

Each employee "counselor" was paid a base salary of \$x. A "counselor" received a production incentive on a monthly basis for all new DMP enrollments over \$x per month. The incentive was equivalent to x% of production between \$x and \$x plus an incentive equivalent to x% of production over \$x.

Supervisor level I was paid a base salary of \$x. They also received an incentive equivalent to x% of the production of all "counselors" under the supervisors direct hierarchy providing the "counselor" attained their goals.

Supervisor level II was paid a base salary of \$x. They also received an incentive equivalent to x% of the production of all "counselors" under the supervisors direct hierarchy providing the "counselor" attained their goals.

The President was paid an annual base salary of \$x with an incentive equivalent to x% of the production of all "counselors"

Employees were given a "phone script" to use to sell the DMP program. The phone script contained minimal educational materials. It was aimed directly at enrolling an individual in a DMP. The script stated that ORG charged a monthly service fee of \$x per creditor account with a maximum of \$x. It also asked for a "one-time enrollment contribution" which was equivalent to the 1st monthly payment on the debt management plan. The script referred to this payment as the clients "first monthly payment towards the program." This payment did not go to the creditors. It was retained entirely by ORG. The script directs the employee to explain the following section clearly to the potential client:

"As we are a section 501(c)(3) non-profit organization, we receive contributions from our clients and the creditors. We will request a one-time enrollment contribution, which is your first monthly payment on the program. However, this contribution is returned to you upon completion of the program, by refunding your last monthly payment to you. There is also a seven-dollar monthly contribution per account, which is included in the payment. This contribution will be offset by the reduced interest rates and lower monthly payments that we have set up for you. On average, most consumers' savings in the first 6 months will equal or exceed their contribution."

In a typical call to a potential client, the employee introduces himself and states that

he is a credit advisor with ORG. He advises that he is calling in reference to the potential client's application that was recently submitted for a bill consolidation. He states that ORG is an IRS approved 501(c)(3) non-profit organization that can significantly reduce the amount of time it takes to eliminate the applicable debt, in most cases saving over 15 years of payments and thousands of dollars in interest. The employee asks the potential client what types of bills he is looking to consolidate, how many accounts he has, the total balance due to the creditors, the status of the accounts with the creditors and what he is looking to accomplish from the consolidation. The employee would then complete a budget sheet with the potential client to determine if ORG could "help the client". If it was determined that ORG could, the employee would inform the potential client that he would have to send one payment per month to ORG on a date of the client's choosing. A supervisor would then calculate the monthly payment for the potential client. The employee would give the potential client the calculated payment amount, interest rate and payoff term. If the potential client agreed to the payment amount, the employee would inform the potential client that he needed to complete paperwork and return it via fax to the employee in order to get started. The forms that were required to be completed and returned by fax included a Debt Management Agreement, a Creditor Information Worksheet, a Debit Form and a Budget Sheet. The initial call could last from thirty minutes to an hour. A follow-up call could last from ten to fifteen minutes.

When a potential client agreed to a DMP, he signed a "Debt Management Agreement", which provided the amount of the monthly payments. It also provided, "I have agreed to make, in addition to my monthly payment to ORG, a one-time, voluntary, non-refundable contribution to ORG of an amount equal to my first anticipated payment to my creditors under the Debt Management Plan at the time of enrollment and when adding creditor accounts to my program". Accordingly, the first payment was retained by ORG and not distributed to creditors. Payments under the DMP began only when the second payment was made to ORG. The agreement also provided that the minimum monthly payment would include a "voluntary contribution to ORG of seven dollars per month per creditor account, with a minimum of twenty-five dollars to help ORG meet its costs of operation, and a maximum of seventy-seven dollars".

Once a potential client signed up to participate in a DMP, the entire account was transferred to a back office processor. ORG retained no control over the account. During the years under examination, ORG had in place a Fulfillment Agreement with UU. UU was a for profit corporation owned by NN. According to the terms of the Fulfillment Agreement, UU provided fulfillment, back office, and customer relations services for DMP clients of ORG. This would include the following: (i) preparing a proposal to creditors reflecting the DMP approved by the client; (ii) communicating the proposal to the creditors; (iii) negotiating with the creditors any necessary or appropriate changes in the proposal; (iv) obtaining the client's approval to any changes to the DMP negotiated with the creditor's; (v) receiving, depositing, and disbursing client DMP payments; (vi) negotiating with clients any claims from clients for refunds and disbursing funds; (vii) receiving and remitting to ORG all direct fair share contributions from creditors; and (viii) responding promptly to client

inquiries regarding disbursements and balances. ORG had three bank accounts that were utilized by UU during the processing function. There were two creditor accounts and one operating account. Signature authority was held by the CEO of ORG. Monthly payments, except for the first payment which was retained by ORG, were made by the client to an ORG bank account which was controlled by UU. UU business depended entirely on debt management plan clients that were provided by credit counseling agencies such as ORG, that have been recognized by the IRS as exempt under section 501(c)(3) of the Internal Revenue Code. ORG provided all the work of soliciting and enrolling clients in DMPs. Once UU received the client documentation, ORG had virtually no further contact with the client.

In addition to distributing payments to creditors, UU solicited "fair share" contributions from credit card companies. The term "fair share" refers to a payment made by the credit card companies that was receiving payments pursuant to a DMP. Typically, credit card companies pay a "fair share", which is a stated percentage of debt, to credit counseling organizations that set up DMPs. The amount paid is generally determined by each creditor in advance. Credit card companies will only make "fair share" payments to organizations that are recognized as exempt under section 501(c)(3) of the Internal Revenue Code. UU collected and disbursed "fair share" payments to ORG.

According to the terms of the Fulfillment Agreement in place during the years under examination, ORG compensated UU by paying a one-time fee of x (\$ x) per new DMP client and a monthly fee of between x (\$ x) and x (\$ x) for processing each client's DMP.

A sample DMP calculation would be as follows. If a client had x creditors and ORG calculated a total payment to creditors of \$ x , the monthly service fee would be \$ x (\$ x per creditor per month not to exceed \$ x). The monthly payment would, therefore, equal \$1070 (\$ x plus \$ x). ORG would also charge the client a one-time enrollment contribution of \$ x . The enrollment contribution was equal to one monthly payment and the client would be required to submit the initial payment for \$ x and the signed Service Agreement upon execution of the agreement. None of this payment would go to a client's creditors. This is the one-time enrollment contribution charged by ORG. Disbursements to creditors by ORG would not start until after it received the client's second payment.

If a potential client did not have enough income to make the monthly payments required under DMP, the client was not placed in a DMP. During the years under examination, there were no procedures in place for the employee counselors to follow-up after the initial contact with such an individual. There were also no records kept on these individuals. When an individual was placed in a DMP, there were no periodic reevaluations of the individual's financial situation. Any modifications to the DMP would be made by the back office processor, UU. ORG had no internal records of any modifications that were made to a client's DMP.

According to its original Form 1023 application, the organization was formed to assist predominantly low income individuals and families with their financial problems. When asked what class of individuals was served by ORG, the organization responded that ORG serves anyone that has a debt problem. It also stated that the client base ranges from doctors to individuals who work in factories. ORG does not, therefore, serve a charitable class. According to the original Form 1023 application filed for ORG, fees would be reduced or waived for indigent clients. Of the approximately x clients that were enrolled in a DMP during the tax year ending June 30, 200X, approximately x clients did not pay any portion of the enrollment fee for some reason. This is less than x% of all DMP enrollments. Approximately x individuals did not pay any portion of the requested monthly service fee for some reason. This is less than x% of all DMP enrollments. Substantially all of the individuals who purchased a DMP paid all requested fees.

In the original Form 1023 application, it was stated that the organization expected to receive contributions from religious organizations, civic groups, labor organizations, businesses, and educational organizations participating in the public information activities. During tax years ending June 30, 200X and 200X, ORG did not solicit or receive any contributions from the above sources. Per a review of the Forms 990 for the tax years ending June 30, 200X and 200X, x% of the total revenue received was generated from the administration of the debt management programs.

ORG advertised its services on its website, www.ORG.com, which made its online debut in 199X. There were also brochures used in 200X and 200X to publicize its services. The brochures were used to generate client interest in its debt management program. In the brochures, ORG claims: " They go on to state, "Our certified account specialists offer you personal, one-on-one counseling and are ready to answer any questions you have regarding our services." The brochures promise to reduce monthly payments by x-x%, reduce or eliminate interest rates, eliminate late charges, eliminate over-the-limit fees, etc. Although ORG deals primarily with credit card debt, the brochure states that the DMP can handle unsecured credit cards, unsecured bank loans, hospital and medical bills, lawyer's bills, tax debt, student loans, etc. The organization never mentioned on its website or in its brochures that a fee was charged for its services.

In addition, ORG purchased valid debt consolidation leads from UU (hereinafter "UU") and other lead generating entities. ORG solicited clients by using the leads that it purchased. It would pay \$x per valid lead and would purchase up to x leads per month.

Private Benefit

In FYE 200X, NN resigned as President and member of the Board of ORG to form the back office processing company UU. NN also owned the for profit lead generation company UU.

According to the July x, 200X minutes of the taxpayer's Board of Directors meeting, NN made a proposal. He proposed that he would set up a new for profit corporation, that he would own, that would take over the complete set up and administration of the DMP's that ORG contracted for with clients. This new company would be called UU Both he and NN would resign immediately as directors and officers of ORG. Two new ORG officers, NN and NN were elected at this meeting. According to the minutes of subsequent Board of Directors meetings, NN, CEO of UU and/or NN, CFO of UU attended ORG Board of Directors meetings as consultants.

In December, 200X, NN was hired as CFO of ORG and elected to the Board of Directors. She was previously employed as a bookkeeper at UU, an entity owned by NN which later became UU and eventually ORG. She was also formerly the CFO of UU.

In March, 200X, NN was hired as President and CEO of ORG, replacing NN. Prior to March, 200X, NN had been in business in a field completely unrelated to the credit counseling industry, and had no relationship to the individuals who had previously founded or operated ORG or to NN for profit businesses. NN stated in an interview that he answered a blind NP advertisement (ie. the employer's name was not stated in the advertisement). He submitted a resume in response to the blind advertisement and was contacted by the UU Human Resources Department. NN went through a series of interviews at UU's offices with NN, CFO of UU, NN, President of UU, NN, a Director of ORG, and NN, a Director of ORG. Eventually, NN was offered a position. He stated that he had been under the impression that the position for which he was interviewing was with UU because it was primarily UU executives who interviewed him. After he was offered a position, he was informed that the position he was being offered and for which he was interviewed, was as President and CEO of the non-profit ORG.

Upon being hired, NN was directed by the UU executives to restructure the operations of ORG, which he was told were out of control under NN. He gave NN a new title and attempted to work with him. NN of UU monitored NN actions at ORG and pressed for removal of NN. Under pressure from NN, NN eventually fired NN. Even though ORG had no formal written severance policy, NN directed NN to give NN x weeks severance pay.

NN indicated that there was a non-written agreement between the ORG Board of Directors and UU whereby NN was to act as an informal consultant to the ORG Board. In fact, NN stated that he had never attended an ORG Board of Directors meeting where an UU representative was not present. NN also stated that he had tried, but was unable to exclude non-ORG Board

members (UU representatives) from attending ORG Board of Director's meetings.

When NN took over as President and CEO of ORG in March, 200X, ORG had in place a contract with UU for back office processing services, also known as the Fulfillment Agreement. There was no evidence presented that showed that at the time this Fulfillment Agreement was entered into with UU, ORG made any attempt to shop around for the best price, terms and service that it could secure for back office processing services.

The Fulfillment Agreement in place with UU during the years under audit did provide for termination of the contract, however, it provided for automatic renewal if it was not affirmatively terminated.

The Fulfillment Agreement required that UU provide ORG with client information, however, there was no specification on what form the information could take. NN was not confident that the ORG Board of Directors would permit the termination of the back office processing contract with UU under any circumstances. Moreover, he was doubtful that he would be able to provide a smooth transition to another processor without the cooperation of UU, even if it was allowed by the ORG Board.

NN was doubtful that the ORG Board of Directors would permit him to replace the contract that ORG had with UU even if he were able to find a more favorable arrangement. Nonetheless, while he was employed with ORG, he solicited bids from other back office credit counseling processors (UU, UU, UU, UU, UU, UU,) to attempt to reduce costs while maintaining service. For example, UU quoted a \$x set up fee and \$x monthly recurring fee compared to UU \$x set up fee and \$x monthly recurring fee, however, there were differences in the level of services offered. The contract with UU provided additional customer service support. UU never completed his search for a replacement back office processor.

NN, although he was given the position of President and CEO of ORG, lacked any true power. As a Director of ORG, NN, was in effect NN superior making his authority as President and CEO questionable. She was also CFO of ORG. NN does not have a college degree and is not a CPA. NN stated NN is a former employee of UU and a close friend of NN. In fact, during the audit, in approximately August, 200X, when NN began making inquiries to unrelated entities to try to secure a more favorable back office processing agreement, he was fired.

Lack of Educational Activities

In addition to its DMP operations, ORG claims to engage in educational activities such as preparing videos, pamphlets and other educational materials and providing these materials free of charge to religious organizations, civic groups, labor unions, businesses, and educational organizations, as well as, providing knowledgeable speakers for these organizations. During tax years ending June x, 200X and 200X, ORG conducted minimal educational outreach activities. The organization stated that they "presented to Employee Assistance Programs, but not a numerous amount." No documentation was kept showing dates, times, or groups addressed. The amount of time devoted to outreach activities was minimal compared to ORG' primary activity of selling DMPs. The organization's website didn't include an education section until tax year ending June x, 200X. Moreover, this could only be viewed by individuals who had access to the internet. Also, in 200X, the organization began distributing a package to potential clients called the "

". It was an interactive booklet and a CD on money, debt and credit that potential clients were given. The organization purchased this package from a vendor. A computer was needed to work through the program. There was little evidence to show that the primary activity of the employees of ORG was anything other than the telephone solicitation and selling of DMPs to individuals in debt.

LAW

Section 501(a) of the Internal Revenue Code provides that an organization described in section 501(c)(3) is exempt from income tax. Section 501(c)(3) of the Internal Revenue Code exempts from federal income tax corporations organized and operated exclusively for charitable, educational, and other purposes, provided that no part of the net earnings inure to the benefit of any private shareholder or individual. The term charitable includes relief of the poor and distressed. Income Tax Regs. Section 1.501(c)(3)-1(d)(2).

The term educational includes (a) instruction or training of the individual for the purpose of improving or developing his capabilities and (b) instruction of the public on subjects useful to the individual and beneficial to the community. Treas. Reg. § 1.501(c)(3)-1(d)(3). In other words, the two components of education are public education and individual training.

Section 1.501 (c)(3)-1 (a)(1) of the Regulations provides that, in order to be exempt as an organization described in section 501(c)(3), an organization must be both organized and operated exclusively for one or more of the purposes specified in such section. If an organization fails to meet either the organizational test or the operational test, it is not exempt.

Section 1.501 (c)(3)-1(c)(1) of the regulations provides that an organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities that accomplish one or more of such exempt purposes specified in section 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose. The existence of a

substantial nonexempt purpose, regardless of the number or importance of exempt purposes, will cause failure of the operational test. Better Business Bureau of Washington, D.C. v. U.S., 326 U.S. 279 (1945).

Educational purposes include instruction or training of the individual for the purpose of improving or developing his capabilities and instruction of the public on useful and beneficial subjects. Treas. Reg. § 1.501(c)(3)-1(d)(3). In Better Business Bureau of Washington D.C., Inc. v. United States, 326 U.S. 279 (1945), the Supreme Court held that the presence of a single non-exempt purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly exempt purposes. The Court found that the trade association had an "underlying commercial motive" that distinguished its educational program from that carried out by a university.

In American Institute for Economic Research v. United States, 302 F. 2d 934 (Ct. Cl. 1962), the Court considered the status of an organization that provided analyses of securities and industries and of the economic climate in general. The organization sold subscriptions to various periodicals and services providing advice for purchases of individual securities. Although the court noted that education is a broad concept, and assumed for the sake of argument that the organization had an educational purpose, it held that the organization had a significant nonexempt commercial purpose that was not incidental to the educational purpose and was not entitled to be regarded as exempt.

The Service has issued two rulings holding credit counseling organizations to be tax exempt. Rev. Rul. 65-299, 1965-2 C.B. 165, granted exemption to a 501(c)(4) organization whose purpose was to assist families and individuals with financial problems and to help reduce the incidence of personal bankruptcy. Its primary activity appears to have been meeting with people in financial difficulties to "analyze the specific problems involved and counsel on the payment of their debts." The organization also advised applicants on proration and payment of debts, negotiated with creditors and set up debt repayment plans. It did not restrict its services to the needy. It made no charge for the counseling services, indicating they were separate from the debt repayment arrangements. It made "a nominal charge" for monthly prorating services to cover postage and supplies. For financial support, it relied upon voluntary contributions from local businesses, lending agencies, and labor unions.

In B.S.W. Group, Inc. v. Commissioner, 70 T.C. 352 (1978), the court found that a corporation formed to provide consulting services was not exempt under section 501(c)(3) because its activities constituted the conduct of a trade or business that is ordinarily carried on by commercial ventures organized for profit. Its primary purpose was not charitable, educational, nor scientific, but rather commercial.

The court found that the corporation had completely failed to demonstrate that its services were not in competition with commercial businesses. The court found that the organization's financing did not resemble that of a typical 501(c)(3) organization. It had not solicited, nor had it received, voluntary contributions from the general public. Its only source of income was from fees for services, and those fees were set high enough to recoup all projected costs, and to produce a profit. Moreover, it did not appear that the

corporation ever planned to charge a fee less than "cost." And finally, the corporation had failed to limit its clientele to organizations that were section 501(c)(3) exempt organizations.

Rev. Rul. 69-441, 1969-2 C.B. 115, granted 501(c)(3) status to an organization with two functions: it educated the public on personal money management, using films, speakers, and publications, and provided individual counseling to "low-income individuals and families." As part of its counseling, it established budget plans, *i.e.*, debt management plans, for some of its clients. The debt management services were provided without charge. The organization was supported by contributions primarily from creditors. By virtue of aiding low income people, without charge, as well as providing education to the public, the organization qualified for section 501(c)(3) status.

In the case of Consumer Credit Counseling Service of Alabama, Inc. v. U.S., 44 A.F.T.R. 2^d 78-5052 (D.D.C. 1978), the District Court for the District of Columbia held that a credit counseling organization qualified as charitable and educational under section 501(c)(3). It fulfilled charitable purposes by educating the public on subjects useful to the individual and beneficial to the community. Treas. Reg. § 1.501(c)(3)-1(d)(3)(i)(b). For this, it charged no fee. The court found that the counseling programs were also educational and charitable; the debt management and creditor intercession activities were "an integral part" of the agencies' counseling function and thus were charitable and educational. Even if this were not the case the court viewed the debt management and creditor intercession activities as incidental to the agencies' principal functions, as only approximately 12 percent of the counselors' time was applied to debt management programs and the charge for the service was "nominal." The court also considered the facts that the agency was publicly supported and that it had a board dominated by members of the general public as factors indicating a charitable operation. See also, Credit Counseling Centers of Oklahoma, Inc. v. United States, 79-2 U.S.T.C. 9468 (D.D.C. 1979), in which the facts and legal analysis were virtually identical to those in Consumer Credit Counseling Centers of Alabama, Inc. v. United States, discussed immediately above.

The organizations included in the above decision waived the monthly fees when the payments would cause a financial hardship. The professional counselors employed by the organizations spent about 88 percent of their time in activities such as information dissemination and counseling assistance rather than those connected with the debt management programs. The primary sources of revenue for these organizations were provided by government and private foundation grants, contributions, and assistance from labor agencies and United Way.

Outside the context of credit counseling, individual counseling has, in a number of instances, been held to be a tax-exempt charitable activity. Rev. Rul. 78-99, 1978-1 C.B. 152 (free individual and group counseling of widows); Rev. Rul. 76-205, 1976-1 C.B. 154 (free counseling and English instruction for immigrants); Rev. Rul. 73-569, 1973-2 C.B. 179 (free counseling to pregnant women); Rev. Rul. 70-590, 1970-2 C.B. 116 (clinic to help users of mind-altering drugs); Rev. Rul. 70-640, 1970-2 C.B. 117 (free

marriage counseling); Rev. Rul. 68-71, 1968-1 C.B. 249 (career planning education through free vocational counseling and publications sold at a nominal charge). Overwhelmingly, the counseling activities described in these rulings were provided free, and the organizations were supported by contributions from the public.

The Credit Repair Organizations Act (CROA), 15 U.S.C. § 1679 *et seq.*, effective April 1, 1997, imposes restrictions on credit repair organizations, including forbidding the making of untrue or misleading statements and forbidding advance payment, before services are fully performed. 15 U.S.C. § 1679b. Significantly, section 501(c)(3) organizations are excluded from regulation under the CROA.

The CROA defines a credit repair organization as:

- (A) any person who uses any instrumentality of interstate commerce or the mails to sell, provide, or perform (or represent that such person can or will sell, provide, or perform) any service, in return for the payment of money or other valuable consideration, for the express or implied purpose of:
 - (i) improving any consumer's credit record, credit history, or credit rating, or
 - (ii) providing advice or assistance to any consumer with regard to any activity or service described in clause (i).

15 U.S.C. § 1679a(3). The courts have interpreted this definition broadly to apply to credit counseling agencies. The Federal Trade Commission's policy is that if an entity communicates with consumers in any way about the consumers' credit situation, it is providing a service covered by the CROA. In Re National Credit Management Group, LLC, 21 F. Supp. 2d 424, 458 (N.D.N.J. 1998).

Businesses are prohibited from cold-calling consumers who have put their phone numbers on the National Do-Not-Call Registry, which is maintained by the Federal Trade Commission. 16 C.F.R. § 310.4(b)(1)(iii)(B); 47 C.F.R. § 64.1200(c)(2). Section 501(c)(3) organizations are not subject to this rule against cold-calling. Because 501(c)(3) organizations are exempt from regulation under the CROA and the cold-calling restrictions, organizations that are involved in credit repair have added incentives to be recognized as section 501(c)(3) organizations even if they do not intend to operate primarily for exempt purposes.

GOVERNMENT'S POSITION

The purpose of ORG' activities differs substantially from those of the organizations in Rev. Rul. 65-299, Rev. Rul. 69-441, and Consumer Credit Counseling Service of Alabama, Inc. v. U.S. In this case, ORG engages in minimal activities which further an exempt purpose. ORG behaves more like a for-profit corporation rather than a non-profit corporation. ORG functions internally like a profit-driven company. Its "counseling" activity is nothing more than a sales activity. Its "counselors" were the salespersons whose goals were to sell as many DMPs as possible. If an individual did not have enough income to make the monthly payments, he would not be placed in a DMP, and minimal education would be provided. The organization's website did not include an education section until the tax year ending June x, 200X, and this could only be viewed by individuals who had access to the internet. Beginning in 200X, an interactive booklet and CD on money, debt and credit was given to potential clients. The client would need a computer to access this package.

During the years under examination, there were no procedures in place for the employee counselors to follow-up after the initial contact with an individual who did not have enough income to make the monthly payment required for a DMP. There were also no records kept on these individuals. When an individual was placed in a DMP, there was no periodic reevaluation of the individual's financial situation. Any modifications to the DMP would be made by the back office processor, UU. Once UU received a client's documentation, ORG had virtually no further contact with the client. There was no structure set up to allow potential clients to have a face to face meeting with an employee for the purpose of learning money management skills or any other kind of counseling.

The "counselors" were judged, evaluated and compensated in large part on their current week or month's production of new DMP account revenues. ORG marketed and sold DMPs to any consumer who could afford the payments. The organization did not focus on serving a charitable class. Only a small percentage (less than x%) of individuals did not pay the one time enrollment fee. There was no actual counseling provided to consumers who contacted or were contacted by ORG. The compensation structure of employees rewarded volume of enrollment of consumers in DMPs, and did not allow any meaningful credit counseling to take place.

ORG did not engage in any meaningful educational outreach during the tax years ending June x, 200X and 200X. Other than speaking at a minimal number of Employee Assistance Programs or directing an individual to its website (the educational portion of which only began in 200X), there was no evidence of any other meaningful educational activity. There were no records kept on any outreach activity that took place in these years. All phone calls focused on analyzing whether or not the consumer would qualify for a DMP. This was the primary focus of the "counselor."

In addition, ORG has a substantial non-exempt purpose of selling a product, the DMP. ORG was not furthering any charitable or educational purpose by mass

marketing a DMP. ORG advertised on its website and purchased leads in order to generate business. Its employees were compensated partly based on the amount of business they brought in.

Finally, ORG was not supported by contributions from the general public and its services were not limited to a charitable class. Substantially all revenues were generated from the administration of the debt management programs and ORG would offer its services to any client who had a debt problem, as long as that client had sufficient income to make the monthly payments. There was no evidence to indicate that ORG was providing its service for free or substantially below cost to members of a charitable class.

The reason ORG is organized as an exempt organization under section 501(c)(3) of the Internal Revenue Code is to avoid the regulatory scheme of the Credit Repair Organizations Act (CROA), 15 U.S.C. section 1679, et. Seq. CROA was enacted to protect consumers by banning certain deceptive practices in the credit counseling industry. If ORG was a for-profit company, the CROA would prohibit it from charging fees in advance of fully providing services. In addition, if ORG were for-profit, federal law would prohibit it from purchasing leads and making cold calls to potential customers. Because section 501(c)(3) organizations are exempted from the provisions of CROA, ORG is able to engage in deceptive business practices that Congress intended to prohibit when it passed the CROA law. As such, ORG is operated for a substantial non-exempt purpose, the carrying on a business while avoiding federal regulations. In addition, ORG could not collect "fair share" payments from creditors if it did not have tax exempt status. The entire DMP business depends on an organization having tax exempt status.

The "Common Enterprise" of ORG and UU was for the benefit of UU and its principal owner NN. Once a client was enrolled in a DMP, all of the processing related to that client's DMP was turned over to UU. UU collected client payments, including processing fees, and disbursed payments to creditors. ORG provided a steady stream of business to UU. In addition, UU had complete control over the DMPs.

NN, UU's principal owner and the former President and board member of ORG, retained control of ORG through attending board meetings and by having a former CFO of UU hired as CFO and elected to the board of directors of ORG. The DMP operations of ORG provided a private benefit to the for profit companies of NN, with whom ORG did business.

CONCLUSION

In summary, ORG was not operated exclusively for exempt purposes because it did not engage primarily in activities which accomplish an exempt purpose. More than an insubstantial part of the activities of ORG were in furtherance of a non-exempt purpose. In addition, ORG was operated for the purpose of serving the private benefit of UU and UU and their principal rather than any public interest. Accordingly, it is determined that ORG is not an organization described in section 501(c)(3), and is not exempt from income tax under section 501 of the Internal Revenue Code, effective July x, 200X.